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Supreme Court of the United States

OCTOBER TERM, 1940.

No. 436.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

ESTATE OF JOHN M. ENRIGHT, deceased, JAMES G. ENRIGHT, EMMA E. NEILSON and MILDRED L. ENRIGHT, Executors,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR RESPONDENTS.

JAMES D. CARPENTER, JR.,
Counsel for Respondents.

Pandick Press, Inc., 22 Thames St., New York, U. S. A.

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Supreme Court of the United States

No. 436, October Term, 1940.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* Estate of John M. Enright, deceased, James G. Enright, Emma E. Neilson and Mildred L. Enright, Executors, Respondents.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR RESPONDENTS.

Opinion Below.

The opinion of the Circuit Court of Appeals is reported in 112 Fed. (2d) 919.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered June 17, 1940. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

(1) Whether Section 42 of the Revenue Act of 1934 requires that there be included as income in the last income tax return of a deceased partner his share of the estimated value of the gross assets of a partnership, consisting of legal services rendered, the value of which is neither known, or due and payable to the partnership, both the partnership and the deceased partner being on the cash basis.

(2) Whether the words "income accrued", as used in Section 42 of the Revenue Act of 1934, include in their meaning a deceased partner's interest in the gross assets of a law partnership, where such assets consist of legal services partly rendered and would not have constituted an accrual to the partnership even had it maintained its books of account on an accrual basis.

Statutes and Regulations Involved.

The pertinent statutes and regulations are set forth in the Appendix, *infra*, pages 31-35.

Statement of Facts.

The facts of the case established by stipulation (R. 25-33) and testimony (R. 22-25) may be summarized as follows:

John M. Enright (hereinafter referred to as the decedent) died testate, a resident of Freehold, Monmouth County, New Jersey, on November 19, 1934.

The decedent, up to the time of his death, was the senior partner of the law firm of McDermott, Enright & Carpenter,

engaged in the practice of law in Jersey City, New Jersey. The books of account of this partnership were kept upon a calendar year cash receipts and disbursements method of accounting (R. 26). The decedent reported his income on the cash receipts and disbursements method of accounting.

The interest of decedent at the date of death in the cash on hand in the firm bank accounts was $4,143.81, which sum was included as income accrued to the date of death in the income tax return filed by the executors (R. 28).

The other assets in the firm consisted of accounts receivable considered collectible, decedent's interest being $2,055.55, and "over 400 pending cases in which work had been done and on which additional work had to be done before the amount of fees to be charged could be determined and the cases billed to clients" (R. 28).

After decedent's death, the senior surviving partner, for estate and inheritance tax purposes, made an appraisal of all the cases in the office at the date of death and determined that the probable amount that had been earned to the date of death, including the probable realizable cash disbursements, aggregated $118,422.51. Decedent's interest at 34½ per cent. thereof was $40,855.77. The aggregate of decedent's interest in accounts receivable of $2,055.55, plus said amount of $40,855.77, was $42,911.32, which was reported in the Federal estate tax return and in the New Jersey transfer inheritance tax return as decedent's interest in the business of the firm as of the date of death (R. 28).

The firm had nine matters pending at the date of death in which work was being done on a fixed fee basis and Mr. Enright's share of the amounts earned in said matters to the date of death was $1,024.89 (which was included in the sum of $42,911.32). In none of such matters were the

fees payable at the date of death but they were payable on a per month or per annum basis at future dates. Practically all other pending matters in the partnership were being handled on the basis of the firm being paid a reasonable fee for the work done, taking into account the amounts involved, the results accomplished for clients, and the time and effort devoted to the cases. A few cases were being handled for clients on a contingent fee basis in which the amount of fee ultimately realizable depended solely upon success. The amounts payable to the firm upon the completion of the business also depended upon the client being satisfied with the amount of fee charged (R. 28-29).

It was agreed between the executors and the senior surviving partner that the estimate of decedent's interest in the firm business of $42,911.32 was to be used for the purposes of the Federal and State estate tax returns and that the amount ultimately realizable for the estate of deceased as Enright's earned proportion at the date of death in the unfinished business of the firm might ultimately be greater or less than the estimate (R. 29).

The partnership, decedent's estate, and all the individual members of the firm filed their income tax returns on the cash basis (R. 29).

Between the date of death and February 2, 1939, the successor firm paid to petitioners in liquidation of decedent's earned proportion of the receipts from business that was in the office at the date of death, $45,965.15 (R. 30).

In the partnership returns filed by the firm (Form 1065) for 1934, 1935 and 1936, the amount paid the Enright Estate was shown in each year as to amount as "capital to estate in liquidation" (R. 31).

As each case was closed and the fee paid, Mr. Carpenter re-examined the charge sheets to determine whether

the amount originally estimated as decedent's interest therein to the date of death was correctly stated. In some cases the amount estimated was increased, whereas in other cases it was decreased. Some moneys were collected by the firm which were not shown on the books at the date of death and the executors were paid decedent's interest therein. The liquidation has not yet been completed (R. 31).

It was further stipulated that the successor firm did not buy decedent's interest but paid his estate, after it was received, his percentage of the outstanding accounts collected and his earned proportion of the unfinished business after the fees were collected by the firm. His executors from time to time were paid exactly what decedent was entitled to on strict liquidation with no deductions from said amount (R. 32-33).

Mr. Carpenter, the senior surviving member of the firm, testified that he started to appraise all matters in the office the day Mr. Enright died but did not finish until nearly a year later. This appraisal was made for the purpose of Federal estate tax and the State of New Jersey transfer inheritance tax on the estate. "We had to do this in order to know what his gross estate was on which to pay such taxes" (R. 23).

Mr. Carpenter testified:

> "I know from my knowledge of the business in the office and how it was handled and what has happened that had we not continued the business with considerable success and good fortune, we would not have realized the amount we have ultimately realized, nor could we have realized the amount I estimated. Some of the firm business was the representation of receivers and trustees, executors and administrators, and allowances in our State in such matters are subject to the approval of the courts, in fact, they are

made by the courts. I am perfectly confident in those cases had the successor firm not been formed to carry on the business and had we sent out bills or applied for allowances to date, we never could have realized and the court would not have ordered any such per diem rate as we ultimately received, and I am confident that hard work and perhaps some good fortune increased the amount anticipated. In many cases it indicates that we received a per diem rate over what I had originally estimated.

"Mr. Enright and all his partners were in 1934 and always have been on a cash basis and none of them has ever been on an accrual basis. So is the firm" (R. 23).

The Board of Tax Appeals held that decedent's share of the accounts receivable and estimated unfinished business of the partnership should be included in his gross income for that period (R. 15). On appeal the Circuit Court of Appeals for the Third Circuit reversed the decision of the Board (R. 34).

POINT I.

(Answering Petitioner's Argument No. 1 at pages 10 to 19.)

The decision of the Circuit Court of Appeals for the Third Circuit holding that the established rules for computing and taxing partnership income are not affected by the provisions of Section 42, is sound.

The Government contends that the income computing method of the partnership is not determinative of "amounts accrued up to the date of his death" of a deceased partner

in the income of the partnership. The Government also contends that the estimated value of services rendered by decedent up to the date of his death is income accrued within the meaning of Section 42 of the Revenue Act of 1934 and that it is immaterial that the estimated value of services rendered by decedent should ever have been distributable to him during his lifetime.

In support of its contentions, *Guaranty Trust Co.* vs. *Commissioner,* 303 U. S. 493, and *Bull* vs. *United States,* 295 U. S. 247, are cited as authorities. Respondents submit that neither decision supports the position of the Government. The Government, on page 15 of its brief, concedes that in each of these cases the income which was taxed to the decedent was actually in the treasury of the partnership at the date of death.

Guaranty Trust Co. vs. *Commissioner, supra,* involved construction of Section 182(a) of the Revenue Act of 1932 respecting the amount to be included in the last return of a deceased partner, where the taxable year of the partner differed from that of the partnership. This Court held that at dissolution the *partnership* income which had been realized to the date of death under *its* method of accounting, became distributable; and that decedent's share of such income was includible in his last return. This Court in construing the provisions of the statute involved stated (p. 500):

> "* * * The object is * * * to make certain that 'the amount so included' in a partner's taxable income 'shall be based upon the income of the partnership' distributable during the partner's taxable year. * * *"

In the *Guaranty Trust* case this Court recognized that the taxable income of a deceased partner in the income of

the partnership is his distributable share of the *partnership income* determined according to *its* income computing method.

> "By these provisions" (Sections 182 to 188) "the taxable income of a partner is limited to that share of the partnership earnings to which he becomes entitled within his taxable year, but it includes all the distributive share of the partnership income which accrues to him in that year even though earned in an accounting period not wholly within the year, and though his return, as in the case of decedent, is on the cash receipts and disbursements basis" (p. 498).

In *Bull* vs. *United States, supra,* this Court held that the item of $24,124.20 was decedent's share of the income of the partnership according to its method of accounting, and should be included in decedent's gross income to the date of death. In that case this Court was concerned solely with profits *actually received by the firm* prior to the partner's death. Since all the income was received by the firm prior to decedent's death this Court did not use the word "earned" meticulously, because there was no question of accrual presented to the Court.

The decisions of this Court in *Guaranty Trust Co.* vs. *Commissioner, supra,* and in *Bull* vs. *United States, supra,* duly recognize that the distributive share of a deceased partner is to be computed according to the income computing method of the firm and in compliance with the partnership agreement. The contention of the Government that the distributive share of a deceased partner is to be computed irrespective of the method of accounting used by the partnership, is not supported by either of the above decisions of this Court.

A.

By express provision in the 1934 Act, Section 42 has no application to the method of determining a partner's distributive share of the partnership income.

That the Circuit Court of Appeals correctly construed Section 42, as amended, is evident from the arrangement of the Revenue Act itself.

> Section 4 provides that the application of the General Provisions is "subject to the exceptions and additional provisions" of the Supplemental Provisions, therein enumerated.
>
> Section 42 is a General Provision of the Act applying to all taxpayers not otherwise specifically provided for elsewhere in the said Act.
>
> Sections 181, 182, 183 and 187 on the other hand, are Supplemental Provisions of the Act applying to a special class of taxpayers, to wit:—Partnerships.

So that, as to a partnership as such, its method of accounting, its computation of the distributive shares of its partners, etc., the provisions of Sections 181 to 188 are controlling and Section 42 has no application.

This view is supported by Article 42-3 of Regulations 86 of the United States Treasury Department, which states:

> "* * * As to the distributive share of the profits of a partner in a partnership, see section 188 * * *." [Sec. 188 was a printer's error. It should have been 182 and was corrected in regulations printed in 1935.]

Accordingly, where the partnership is on a cash basis, a deceased partner's executor under Section 182 is bound

to report only his distributive share of the cash basis net income of the partnership at death. He is not bound to report the deceased partner's share of all the partnership accrued income on the theory that it is cash on hand available for distribution. For stronger reasons, the executor is not required to report as income accrued, the deceased partner's share of the total assets of the firm, as the Commissioner determined in this case.

Moreover, Section 42 is found in Part IV of Subtitle B of the Revenue Act entitled "Accounting Periods and Methods of Accounting", while Section 182 is in Supplement F devoted to "Tax of Partners". Therefore, the only possible conclusion that can be drawn is that Section 42 is devoted to accounting problems, while Section 182 lays down the law as to the method of determining tax on the distributive share of a partner in a partnership.

In addition, there is no provision anywhere in the 1934 Act requiring a compulsory change by a partnership of its method of accounting, in the event of the death of a partner.

When Congress in 1934 enacted Section 42, it was fully cognizant of Section 182, which originated in the Revenue Act of 1921, and yet made no attempt to alter or amend it. On the contrary, by Section 4, it made Section 182 supreme.

Thus, since 1921, a *partner* who used the cash receipts and disbursements method of accounting in keeping his individual books has been required by Section 182 to report as an item of gross income, his *distributive share* of the net income of the partnership, in the same manner as though he were on an accrual basis. And since 1921 where such a *partner* died during the taxable year, his executor or administrator was required by Section 182 to report as an item

of gross income the deceased partner's *distributive share* of the income of the *partnership* computed according to *its* method of accounting, in the same manner as though said partner were on an accrual basis.

Nichols vs. *United States*, 64 Ct. Cl. 241; cert. den. 277 U. S. 584;

City Bank, etc. vs. *Commissioner*, 29 B. T. A. 190;

Hall, et al., Executors vs. *Commissioner*, 24 B. T. A. 1;

Goldman vs. *Commissioner*, 15 B. T. A. 1341.

Both Section 182 and Section 42 have for their sole purpose the prevention of income escaping taxation which would ordinarily escape where the taxpayer uses the cash receipts and disbursements method of accounting. Section 42 seeks to accomplish with respect to the income of a decedent who used the cash receipts and disbursements method of accounting, exactly that which has been accomplished since 1921 by Section 182 with respect to the *distributive share* of a partner in the income of a partnership, whether the partner is living or dead. In the case of the death of a taxpayer, who had been reporting on a cash basis, Section 42 makes it mandatory that the method of accounting be changed to an accrual basis. In the case of a living or dead partner who uses the cash receipts and disbursements method of accounting, Section 182 makes it mandatory that with respect to a special item of gross income, to wit;—his *distributive share* of the income of the partnership—he use the accrual method of accounting.

Section 182 has for years been a special section of the Revenue Acts applying to a special type of gross income, while Section 42 is a general provision of the Revenue Act

of 1934, applicable to all types of income, not otherwise specifically provided for in the Act. It is submitted that inasmuch as Congress did not alter or amend Section 182 at the time of the enactment of the 1934 Amendment to Section 42, the latter section as amended has no application to this special type of gross income, to wit;—the *distributive share* of a partner in the income of the partnership.

B.

Partnerships have always been regarded by the Income Tax Laws as distinct income computing entities.

In the Revenue Act of 1934, as in earlier and later Revenue Acts, partnership income is computed and taxed in accordance with well established rules. A partnership is treated as a tax computing unit separate and distinct from its members. *Johnston* vs. *Commissioner,* 86 Fed. (2d) 732; cert. denied 301 U. S. 683. That a partnership is so treated is clear from the provisions of the Revenue Act itself providing for the computation of partnership income and the filing of partnership returns. *Guaranty Trust Co.* vs. *Commissioner, supra. Archbald* vs. *Commissioner,* 27 B. T. A. 837, affirmed 70 Fed. (2d) 720; cert. denied 293 U. S. 594.

In *Archbald* vs. *Commissioner, supra,* the Board of Tax Appeals recognized that a partnership is a separate and distinct income computing entity from its members, when it stated:

> "* * * The income of partnerships has been required to be computed *quoad* the partnership before ascertaining the taxable distributive shares, and this partnership income is so far distinct from that of the individual partners that it takes its own fiscal year

whenever that year is different from that of the partner, L. O. 816, 1 C. B. (1919) 168; L. O. 972, 2 C. B. (1920) 163; and this, even when it results in a different credit for an individual in partnership from that of an individual sole proprietor. Shearer *v.* Burnet, 285 U. S. 228; Charles Colip, 5 B. T. A. 123. The fact that the tax imposed upon corporations and associations carried an express exception —'not including partnerships'— implies a recognition of the unity of partnership; and the exclusion is only applicable to 'ordinary partnerships', Burk-Waggoner Oil Ass'n *v.* Hopkins, 269 U. S. 110.

"It is clear, therefore, that a doctrinaire assertion that a partnership is not an entity affords no key to the determination. Congress has not taxed partnerships directly; but, apart from that, there is no reason to think that their existence was ignored or that for other purposes under the statute their legal character was not to be fully accepted. W. J. Burns, 12 B. T. A. 1209; Henry W. Healy, 18 B. T. A. 27, 32" (pp. 840-841).

In *Johnston* vs. *Commissioner, supra,* the Circuit Court of Appeals for the Second Circuit stated:

"(1-3) • • • Though a partnership is not a taxpayer (section 181 of the 1932 Revenue Act (26 U. S. C. A., sec. 181 and note)) and each partner is taxed on his distributive share of partnership income (section 182, 47 Stat. 222 (see 26 U. S. C. A., sec. 182 and note)), the partnership is a tax computing unit whose income is to be calculated in the same manner and on the same basis as that of an individual, with the exception that no deductions for charitable contributions are allowable (section 183 of the act (26 U. S. C. A., sec. 183 and note)). See Earle *v.* Commissioner (C. C. A.) 38 F. (2d) 965 • • •."

See also

Walbridge vs. *Helvering,* 70 Fed. (2d) 683;
Finucane vs. *United States,* 21 Fed. Supp. 122;
Klingenstein vs. *United States,* 18 Fed. Supp. 1015.

The recent decision of this Court in *Neuberger* vs. *Commissioner,* No. 5, this Term, is not in point because it involved merely the construction of Section 23(r)(1) of the Revenue Act of 1932 to determine whether the loss of an individual partner could be offset against a partnership gain. The case did not involve the question of the taxability of a partner's *distributive share* of partnership income.

POINT II.

(Answering Petitioner's Argument No. 2, pages 19 to 28.)

It has been firmly established by this Court that the provisions of the Revenue Act are not to be extended by implication beyond the clear import of the language used.

The Government contends that the purpose of Congress in enacting Section 42 was to cover all income earned during the lifetime of a decedent, and that unless all income earned by a decedent during his lifetime is taxed in his last return as income accrued, it escapes taxation.

This contention of the Government is based on the supposition that when Congress employed the word "accrued" in the 1934 amendment to Section 42, Congress intended to

tax all the "earned" income of a decedent up to the date of death.

Section 48(c) of the 1934 Revenue Act completely nullifies the position taken by the Government. That section provides that, as used in Part IV, the term "paid or accrued"

> "* * * shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part."

Article 41-2 of Regulation 86 of the United States Treasury Department states that:

> "Applied standard methods of accounting will ordinarily be regarded as clearly reflecting income."

Since the word "accrued" is, under Section 48(c) to be construed according to a method of accounting, the only logical conclusion is that Congress intended by the enactment of the 1934 amendment to Section 42 to automatically effect a change in the method of accounting of a deceased taxpayer from a cash basis to the accrual basis.

The Government's contention that its contention should be approved to prevent the loss of revenue, is unsound. The argument advanced is that unless the appraised value of decedent's services to the date of death are taxed as income at the time of his death, it cannot be taxed later and the Government will suffer a loss of revenue. The same argument can be applied to increment in the value of any property owned by a decedent at the time of his death. Such increment could not be taxed as accrued income unless the property had been sold prior to the date of death. The mere desire to obtain revenue cannot justify the inclusion in the

income of a decedent of any unrealized increment, under the Sixteenth Amendment. Likewise, the value of services which have not ripened into income at the date of death cannot be classed as income under the said Amendment.

Moreover the contention of the Government seeks to extend, by implication, the provisions of Section 42, as amended. This Court has repeatedly refused so to do.

In *Gould* vs. *Gould,* 245 U. S. 151, this Court held (p. 153):

> "In the interpretation of statutes levying taxes, it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen. United States *v.* Wigglesworth, 2 Story, 369, Fed. Cas. No. 16,690; American Net & Twine Co. *v.* Worthington, 141 U. S. 468, 474, 35 L. ed. 821, 824, 12 Sup. Ct. Rep. 55; Benziger *v.* United States, 192 U. S. 38, 55, 48 L. ed. 331, 338, 24 Sup. Ct. Rep. 189."

See also *United States* vs. *Field,* 255 U. S. 257, 65 L. Ed., 617, and *Smietanka* vs. *First Trust & Savings Bank,* 257 U. S. 602, 66 L. Ed. 391.

A.

Under Section 42 decedent's executors are required to report as income only that which decedent himself would have had to report had he lived and used the accrual method of accounting.

It will be observed that under the general rule of Section 41, a taxpayer is to compute his net income "in accordance with the method of accounting" he regularly employs in keeping his books.

Section 42 deals exclusively with a taxpayer who uses the cash receipts and disbursements method of accounting and provides that he shall report all items of gross income in the taxable year in which they were actually received. The 1934 amendment to Section 42 contains the additional provision that where such a taxpayer dies during the taxable year, his executor or administrator shall report his income in accordance with the accrual method of accounting. This amendment was aimed solely at affecting a change in the taxpayer's individual method of accounting where the taxpayer died during the taxable year, in order to prevent income escaping taxation which would not otherwise escape had the taxpayer regularly employed the accrual method of accounting.

What constitutes accrued income to a taxpayer at his death, who during his lifetime had regularly employed the cash receipts and disbursements method of accounting, is controlled by what would have constituted his income had he lived and used the accrued method of accounting in keeping his books.

It will be further observed that Section 182, in providing that a partner shall report his *distributive share* in the income of the partnership whether distributed to him or not, requires a partner who employs the cash receipts and disbursements method of accounting in keeping his books, to use the accrual method of accounting in reporting his *distributive share* of the income of the partnership.

Accordingly, where both a partner and the partnership used the cash receipts and disbursements method of accounting, the partner is required to report as income his *distributive share* of the moneys on hand in the partnership at the close of the taxable year, *whether distributed to him*

or not. And where the partner is on a cash basis and the partnership employs the accrual method of accounting, the partner is required to report his *distributive share* of the income of the partnership computed according to *its* method of accounting *whether distributed to him or not.*

Therefore, had John M. Enright lived until the end of the 1934 taxable year and employed the accrual method of accounting, he would have been required to report as income from the law partnership of McDermott, Enright & Carpenter for that year, his *distributive share* of the cash in the partnership treasury, whether distributed to him or not (the partnership having employed the cash receipts and disbursements method of accounting).

Enright's death did not place upon his executors any greater obligation than to report as income that which he himself would have been required to report had he lived and employed the accrual method of accounting during his lifetime.

POINT III.

(Answering Petitioner's Argument No. 3, pages 28 to 34.)

Where the partnership and decedent were both on the cash basis, the only accruable item in the partnership, taxable under Section 42, was decedent's share of cash in the partnership treasury.

The Government contends that inasmuch as the evidence does not show the situation with regard to the accounts receivable and the unfinished business of the partnership in sufficient detail, the total amount of decedent's

share of said items was accrued income under Section 42. The Government also contends that the criteria for determining whether an item has "accrued" under Section 42 is not as rigid as that laid down in *Fehrman* vs. *Commissioner,* 38 B. T. A., 37, and cannot have any precise meaning apart from the circumstances of a given taxpayer's case.

The Government's position is untenable. Since the partnership kept its books on the calendar year cash receipts and disbursements basis, and since the income of the partnership computed by such method of accounting, became taxable to the partners at the time it became distributable, regardless of the basis on which the individual income of the partner was computed, any change in a partner's basis, whether voluntary or under Section 42, cannot affect either the amount of the partnership income or the time when the partner's share thereof becomes taxable to him.

A.

Accounts receivable by the firm are not income accrued.

Under Section 182 of the Revenue Act a partner is taxed on his "distributive share" of the partnership net income, whether distributed or not.

Section 183 provides that the net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual.

It is to be observed that Sections 42 and 43 of the Act of 1934 attempt to make the accrual system *exclusive* and *mandatory* as to an individual in the event of death.

What items therefore are the subject of "accrual" as used in the statute?

> "* * * Receipt of income or accrual of the right to receive it within the tax year is the test of taxability, not the time it has taken the taxpayer to earn it nor the duration of his investments which have finally resulted in profit. Lucas *v.* Alexander, 279 U. S. 573."
>
> *Guaranty Trust Company* vs. *Commissioner*, 303 U. S. 493, 498.

> "* * * When the right to receive an amount becomes fixed, the right accrues * * *."
>
> *Spring City Foundry Company* vs. *Commissioner*, 292 U. S. 182, 184-5.

"It is of course true, as the Board points out, that under the accrual method of accounting employed by petitioner, items must be accrued as income when the events occur to fix the amounts due and determine liability to pay. United States *v.* Anderson, 269 U. S. 422, 46 S. Ct. 131, 70 L. Ed. 347. Generally speaking, however, the income tax law is concerned, and its administration should deal only, with realized losses, and realized gains. Lucas *v.* American Code Co., 280 U. S. 445, 50 S. Ct. 202, 74 L. Ed. 538, 67 A. L. R. 1010. The taxpayer therefore, is under no obligation to pay a tax on income he might never receive. North American Oil Consolidated *v.* Burnet, 286 U. S. 417, 52 S. Ct. 613, 76 L. Ed. 1197. A strained construction in administrative efforts to accrue income should be avoided.

"Of the many cases supporting this view, Com'r *v.* Cleveland Trinidad Paving Co., 6 Cir., 62 F. 2nd 85; McPherson *v.* Helvering, 62 App. D. C. 325, 67 F. 2d 749; Burnet *v.* Logan, 283 U. S. 404, 51 S. Ct. 550, 75 L. Ed. 1143; Woods *v.* Lewellyn, 3 Cir., 252 F. 106, may be cited."

Commissioner of Internal Revenue v. *Edwards Drilling Company*, 95 Fed. (2d) 719, 720.

"From the above expressions, it is apparent that the general definition of 'accrued' is limited when taken in connection with income returns. We may conclude that income has not accrued to a taxpayer until there arises to him a fixed or unconditional right to receive it."

H. Liebes & Co. v. *Commissioner of Internal Revenue*, 90 Fed. (2d) 932, 937.

"* * * In order to be accruable in the taxable year for which the return is made, a valid obligation to pay must have existed in that year, which is enforceable on the date when the obligation is due. When, however, the obligation to pay is contingent upon the happening of some future event, there is no certainty that it will be paid or will accrue. In such event, no obligation accrues from a fixed or determinable source and no duty arises or exists in the taxable year which can be accounted for as income under any system of accounting. * * *"

Helvering v. *Russian Finance & Construction Corporation*, 77 Fed. (2d) 324.

See also *United States* vs. *Amalgamated Sugar Company*, 72 Fed. (2) 755, 759; *Elmhirst* vs. *Duggan*, 14 Fed. Supp. 782, 783; *Schoelkopf Aniline & Chemical Works* vs. *United States*, 3 Fed. Supp. 417, 421-2.

B.

Services rendered and not completed or billed by the partnership are not "income accrued" to decedent.

Legal services rendered by a partnership on a *quantum meruit* basis and partly performed cannot possibly be con-

strued as "income accrued" to a partner, living or dead, of a partnership that employs the cash receipts and disbursements method of accounting in computing its income.

Some services were rendered on a fixed charge basis, payable per month or per annum at later dates than date of death. The total amount of such fees earned to the date of death was $1,024.89, which amount was included in the estimate of $42,911.32 (R. 28-29).

The evidence here is that in 55 cases the per diem rate originally estimated was increased; in 22 cases decreased as the final termination of the matters warranted, with the client's approval (R. 31).

In many cases that were being handled by the partnership the clients were receivers, trustees, executors and administrators, and in such cases the fees payable to lawyers in New Jersey are fixed by the Court upon the termination of the matter (R. 24).

Upon liquidation the obligation of the surviving partners, as trustees in liquidation, was (a) to reduce the assets to cash, (b) to pay debts, (c) to distribute the remainder to the surviving partners and the estate of the deceased partner according to the interest of each at the moment of dissolution.

Molineau vs. *Reynolds,* 54 N. J. Eq. 559; 47 Corpus Juris, p. 1042.

We urge that as a matter of law the interest of decedent in his partnership (beyond his share of the distributable cash in the treasury) was not income within the meaning of the 16th Amendment.

Eisner v. *Macomber,* 252 U. S. 189.

C.

Even if the partnership used the accrual method of accounting, it would be improper to include as an item of income the appraised value of the work in process.

A law partnership, unlike commercial partnerships, sells only the services of its members.

Assuming a law partnership that employs the accrual method of accounting in keeping its books, the only item which could properly be accrued on its books would be accounts receivable which are due and payable. And the only accounts receivable which are due and payable to a law partnership are those wherein the services involved are completed and a bill rendered to the client.

Work in process of a law partnership consists of the examination of statutes and authorities, preparation of pleadings, preparation for trials, preparing agreements, indentures, searching titles, writing briefs, and a host of other matters which it is not necessary to attempt to specify.

Ordinarily, until the lawyer's work is completed he cannot expect payment, unless it be for the occasional client who will pay a retainer; or in the unusual situation of a litigation lasting years where payments on account are made as the work progresses.

In *Woodbury* vs. *Andrew Jergens Co.*, 37 Fed. (2d) 749, affirmed 61 Fed. (2d) 736, cert. denied 289 U. S. 740, District Judge Woolsey in discussing the measure of the value of a lawyer's services, stated (p. 750):

> "The value of a lawyer's services is not measured by time or labor merely. The practice of law is an art in which success depends as much as in any other art on the application of imagination—and

> sometimes inspiration—to the subject-matter. The exercise of these faculties may occur at any stage in a case, though their influence on the court of the proceeding may not be established till its outcome."

See also *Shattuck, et al.* vs. *Pennsylvania R. Co.*, 48 Fed. (2d) 346.

It is firmly established that agreements entered into by lawyers with clients are in the nature of unilateral contracts under which the client promises to pay the agreed compensation when and if all the services contracted for have been fully performed.

In A. R. R. 702, I-1 Cumulative Bulletin 1922, page 47, a law partnership charged clients on its books for incomplete legal services rendered. The opinion stated:

> "There is no fixed standard for the determination of the value of legal services, the mere rendition of such services not fixing their value."

In *S. Naitone & Co. Inc.* vs. *Commissioner*, 32 F. (2d) 949, 952, the court held that in a unilateral or conditional contract, the amount may be said to be accrued when it is definitely received.

(A. R. R. 6158, Cumulative Bulletin 1924, p. 75.)

Work in process of a law partnership, because of its peculiar nature, cannot be considered as income accrued even where the partnership employs the accrual method of accounting in keeping its books.

POINT IV.

The purpose of Section 42, Revenue Act of 1934, was to tax what was in fact income; not to attempt to create income and then tax it.

The partnership agreement provides that the earnings of the firm distributable to the partners shall be determined annually on the basis of cash receipts and disbursements. "All receipts subsequent to the date hereof shall be considered as income subject to this agreement, regardless of when earned" (R. 26).

After the death Federal estate tax law (U. S. Code, Title 26, Sections 410 to 427) required the executors to make a return, under oath, setting forth the value of the gross estate of the decedent, the value of the net estate, as defined in Section 411, and the tax paid or payable.

The New Jersey transfer inheritance tax act (P. L., 1934, Chap. 243) contained similar provisions.

To comply with these laws, the senior surviving partner, pursuant to paragraph 5 of the partnership agreement (R. 26), and paragraph eight of decedent's will (R. 27), made an appraisal of the value of decedent's interest in the partnership. The appraised amount was $42,911.32 (R. 28).

The Commissioner and the Board below determined that this sum was income accrued to decedent at the date of death.

An examination of the report of the Ways and Means Committee of the House and the report of the Finance Committee of the Senate on Sections 42 and 43, clearly shows that it is not the purpose of Section 42 to accrue partnership income in computing the income of an individual part-

ner. Only the income of deceased individuals is to be accrued.

In *Fehrman* vs. *Commissioner*, 38 B. T. A. 37 (No. 7) (1938), the general effect of Sections 42 and 43 was carefully considered in the light of the purposes of their enactment, as indicated by the Reports of the Finance Committee of the Senate, and of the Committee on Ways and Means of the House of Representatives. The Board's conclusion was as follows:

> "It is obvious from the language of the act and the legislative intent as disclosed by the committee reports quoted above that the purpose of Congress was to treat the income of a decedent as though *he* were on an accrual basis even though *he* was actually on a cash basis and kept his books on a cash basis, and that the phrase, 'amounts accrued up to the date of his death' means those amounts which would be properly included in a decedent's income if *he* were on an accrual basis as distinguished from a cash basis." (Emphasis added.)

The true purpose of Section 42 was to tax items of income to the taxpayer which under earlier decisions were escaping income taxes prior to 1934. Such were:

Interest. Interest accrued at time of decedent's death is part of corpus and not taxable income. *William K. Vanderbilt*, 11 B. T. A. 291; *Frank H. Clark*, 12 B. T. A. 425. Interest owed before but paid after decedent's death is corpus. *Mellie Esperson Stewart*, 18 B. T. A. 1010.

Salaries. Salary due decedent at date of his death is a capital asset and part of corpus of estate; no income in-

volved if amount received no greater than amount due at death. *Frank H. Clark,* 12 B. T. A. 425.

Rents. Rent owed but not due and payable at decedent's death constitutes part of corpus of estate, and when collected does not become income. *E. S. Heller,* 10 B. T. A., page 53.

Dividends. Article 115-1 requires that a dividend shall be included in gross income when the cash or other property is unqualifiedly made subject to the demands of the stockholder. [Dividends declared prior to the death of a taxpayer which are not payable until after his death constitute accrued income taxable to decedent within the meaning of Section 42. I. T. 2822 C. B. Dec. 1934, p. 54.]

In the case at bar the executors included in decedent's return as income accrued to the date of death decedent's share of the money in the treasury of his partnership (R. 28). The Commissioner assessed a deficiency for omitted accrued interest on bonds, held by decedent individually. The executors promptly paid the resulting tax on this omission (R. 28). Such items were within the true meaning of Section 42.

When, however, the Commissioner construed Section 42 as including within its meaning decedent's entire interest in the total value of the partnership assets as estimated for purposes of Federal estate taxes and transfer inheritance taxes, he erred in that (1) his ruling was contrary to the terms of the Act; (2) then Section 42 became void as an attempt to create as income to the decedent that which was not in fact income to him, in order to tax it.

POINT V.

A broader construction of Section 42 than that made by the Circuit Court of Appeals below would result in the section being unconstitutional and null and void.

The Government seeks to have this Court, by construction, extend the provisions of Section 42 so as to include in gross income, items which Congress has not directed to be included, and which Congress would have no power to tax under the Sixteenth Amendment.

Section 42 as construed by the Board of Tax Appeals would tax as income that which is not income in fact.

Income is taxable only to those persons to whom it is income.

> *Saenger* vs. *Commissioner*, 69 Fed. (2d) 631;
> *Hartley* vs. *Commissioner*, 72 Fed. (2d) 352;
> *Hoeper* vs. *Tax Commissioner*, 284 U. S. 206, 76 L. Ed. 248, 251.

Section 42 as construed by the Board below would be in conflict with the Fifth Amendment of the Constitution and be null and void for the following reasons:

(a) That said section attempts to tax to a deceased partner his share of the estimated value of services performed by his partnership as income accrued to the date of his death, yet income taxes as to all other members of the partnership are assessed as of the date when the partnership receives and distributes the proceeds of services rendered; and

(b) said section is arbitrary, harsh and confiscatory in that, where members of a partnership are all on a cash basis and one dies it makes the fact of death create the entire interest in the partnership of the deceased partner as taxable income, although the interest of the surviving partner or partners is not taxable income to them until the partnership assets are liquidated.

The record shows that while the Estate was taxed on Enright's entire interest in the partnership as income accrued to him in 1934, the other partners were taxed on the income *as it was received* in liquidation over a six year period.

The effect is that Enright's entire interest in the partnership being added in one lump to his 1934 gross income, raises his status in the surtax bracket and the surtaxes are consequently far greater than they would have been had he lived and paid taxes thereon during the years when the income was in fact distributable.

We realize that Courts will not unnecessarily hold an Act of Congress unconstitutional, but if Section 42 was correctly construed by the Board of Tax Appeals, then it must fall as violating the Constitution.

Conclusion.

(1) Decedent's interest in the pending professional undertakings of his partnership was not income within the meaning of the 16th Amendment.

(2) The estate having reported in the estate tax return as required by law, decedent's interest in his law firm and having paid the estate tax thereon, the same amount under

the facts of this case cannot be subjected to an income tax, unless required by express words of the statute.

United States vs. *Supplee-Biddle Hardware Co.*, 265 U. S. 189.

(3) Section 182, Revenue Act 1934, controls the method of accounting for a deceased partner's distributive share of the income of the partnership, and Section 42 has no application.

(4) Decedent's interest in his partnership was in fact capital, not income.

Lillian O. Fehrman, 38 B. T. A. 37;
Bull vs. *United States*, 295 U. S. 247;
City Bank, Ex'r. vs. *Commissioner*, 29 B. T. A. 190.

The decision of the Circuit Court of Appeals for the Third Circuit should be affirmed.

JAMES D. CARPENTER, JR.,
Counsel for Respondents.

APPENDIX.

STATUTES AND REGULATIONS INVOLVED.

Revenue Act of 1934, C. 277, 48 Stat. 680:

SUBTITLE A—INTRODUCTORY PROVISIONS.

* * * * * * *

Sec. 4. SPECIAL CLASSES OF TAXPAYERS.

"The application of the General Provisions and of Supplements A to D, inclusive, to each of the following special classes of taxpayers, shall be subject to the exceptions and additional provisions found in the Supplement applicable to such class, as follows:

(a) Estate and trusts and the beneficiaries thereof—Supplement E.

(b) Members of partnerships—Supplement F.

(c) Insurance companies—Supplement G.

(d) Nonresident alien individuals;—etc." (U. S. C. A. Title 26, Sec. 4.)

SUBTITLE B—GENERAL PROVISIONS.

* * * * * * *

PART IV—ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

"Sec. 41. GENERAL RULE.

"The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in

keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. (U. S. C. A. Title 26, Sec. 41.)

"Sec. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

"The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period" (U. S. C. A. Title 26, Sec. 42).

* * * * * *

"Sec. 48. DEFINITIONS—When used in this title—

"(c) PAID, INCURRED, ACCRUED—The terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part" (U. S. C. A. Title 26, Sec. 48).

SUBTITLE C—SUPPLEMENTAL PROVISIONS.

* * * * * *

SUPPLEMENT F—PARTNERSHIPS.

"Sec. 181. PARTNERSHIP NOT TAXABLE. Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity (U. S. C. A. Title 26, Sec. 181).

"Sec. 182. TAX OF PARTNERS. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year (U. S. C. A. Title 26, Sec. 182).

"Sec. 183. COMPUTATION OF PARTNERSHIP INCOME. The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual" (U. S. C. A. Title 26, Sec. 183).

* * * * * *

"Sec. 187. PARTNERSHIP RETURNS. Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners" (U. S. C. A. Title 26, Sec. 187).

TREASURY REGULATIONS 86, RELATING TO THE REVENUE ACT OF 1934.

"Art. 42-2. *Income not reduced to possession.*— Income which is credited to th account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which

so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A book entry, if made, should indicate an absolute transfer from one account to another. If a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt."

* * * * * * *

"Art. 181-1. *Partnerships.*—Partnerships as such are not subject to taxation under the Act, but are required to make returns of income. (See Sections 187 and 188.) For definition of what the term 'partnership' includes, see section 801 (3)."

* * * * * * *

"Art. 182-1. *Distributive share of partners.*—Individuals carrying on business in partnership are taxable upon their distributive shares of the net income of such partnership, whether distributed or not, and are required to include such distributive shares in their returns. The distributive share of the net income of the partnership which a partner is required to include in his return is his proportionate share of the net income of the partnership, either—

(a) For the taxable year upon the basis of which the partner's net income is computed, or

(b) If the partner's net income is computed upon the basis of a taxable year different from that

upon the basis of which the net income of the partnership is computed, for the taxable year of the partnership ending within the taxable year upon the basis of which the partner's net income is computed.

Amounts earned and distributed to a partner by a partnership after the end of its taxable year and before the end of his corresponding taxable year should be accounted for both by the partnership and by the partner in their returns for their next succeeding taxable year. If the result of partnership operation is a net loss (excess of allowable deductions over gross income), the loss will be divisible by the partners in the same proportion as net income would have been divisible (or, if the partnership agreement provides for the division of a loss in a manner different from the division of a gain, in the manner so provided), and may be taken by the individual partners in their returns of income. If separate returns are made by the husband and wife domiciled in a community property State, and the husband only is a member of a partnership, that part of his distributive share of the partnership's net income which is community property should be reported by the husband and by the wife in equal proportions. In the case of a partnership closely related to other trades or businesses, see section 45."